Fiduciary Fireworks: Framing the Discussion for the SEC

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The following is an excerpt from the Cary M. Maguire Center for Ethics’ submission to the Securities and Exchange Commission’s (SEC) Request for Comment on Standards of Care.

THE CENTER FOR ETHICS in Financial Services does not take advocacy positions on matters of public policy, and we will not do so here. Rather, we will make some observations on the ethical implications of your potential actions and what appear to be your underlying assumptions.

HOW DO WE DEFINE “BEST INTEREST”? 

Advocates of a universal fiduciary standard emphasize the requirement of a fiduciary to make recommendations that are in the best interest of the client. But if we cannot define the term “best interest” in a way that is widely accepted and readily applied, an important part of the legal/technical distinction between fiduciary and suitability standards is undermined.

Perhaps an analogy is helpful. Imagine that a mother wants to purchase the best present for her child’s upcoming birthday. She goes to a local children’s toy superstore and begins to browse.

But which toy is best? Is the best toy the cheapest toy? Perhaps if she spends less money on the toy, there may be additional resources for other wanted items, like swimming lessons. But, maybe the best toy is one made by a well-known brand with a reputation for quality? Then again, maybe the best toy is one that complements the rest of her child’s toys. Perhaps she should purchase a toy to round out a collection of stuffed animals?

But, the mother thinks, Maybe I am on the wrong track. Surely there are other toy stores and one may have a better selection. She could be confident she would get the best toy if she followed a thorough process of looking at multiple local and regional stores and on the Internet. If a mother is truly committed to the best toy, shouldn’t she explore those options as well?

At this point, a reasonable person may object that there are both time and cognitive limitations that come into play; surely the mother has other goals and projects besides finding the very best toy. There has to be some kind of limit. Besides, the mother will somehow know when she’s reached this point; it’s just common sense.

But this is part of the problem: If we cannot define the standard, but instead rely on our rough intuitions of when it has been met (“I know when..."
I’ve looked enough”), then whether one has actually met the standard becomes hopelessly subjective. Trying to add objectivity to the process leads to a muddle: At what point has our beleaguered mother exhausted her obligations?

We can use our analogy to generate two definitions of what it means to recommend products in the best interest of the client.

1. Products in the best interest of the client always possess a certain set of characteristics.
2. Product recommendations that are in the client’s best interest are generated through a certain process.

But most believe that the best product is one that is fairly priced, issued from a good organization and fits well with an overall financial plan. However, once you are required to balance multiple characteristics, it is important to specify which balance is best in an objective way. This takes us back to where we began.

In addition, the suitability standard, it can be argued, is already a process-based (rather than outcome-based) approach. To meet the suitability standards certainly demands both diligence and knowledge. Given the similarities, it may be difficult to differentiate on this basis.

But we do not think it is either of these understandings of the term “best interest” that is operating in the current debate. The tacit understanding seems to be the following:

3. Practitioners compensated on the basis of commissions or limited to the sale of proprietary products are incapable of or unlikely to recommend the best product.

Thus, what it means to recommend products in the best interest of the client is that the recommender simply not be a member of this class of practitioners. While this definition avoids the regressive muddle created by the term best interest, it suffers from its own problems and, moreover, has not been conclusively proven.

CHALLENGES SURROUNDING DISCLOSURE
The second component that advocates argue differentiates the fiduciary standard from the suitability standard is the responsibility of the practitioner to disclose conflicts of interest.

There is a well-defined and fairly exhaustive literature that concerns the well-established problems with the disclosure regime. We will not rehearse that literature here, but simply make the following points:

- Mandated disclosure can be harmful since it creates a form of moral licensing that releases advisors from moral responsibility to act in the best interest of the client (according to Robert Prentice’s 2011 article “Moral Equilibrium: Stock Brokers and the Limits of Disclosure” in Wisconsin Law Review).
- In order for disclosure to be effective, consumers must understand how (and whether) a conflict of interest has influenced the advisor and how to appropriately discount his or her advice. Research shows that consumers consistently fail to do this well (according to “The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest,” by Daylian M. Cain, George Loewenstein and Don A. Moore).
- Research indicates that disclosure requirements focusing on a financial advisor’s education, experience and form of compensation may have little of the desired impact upon low-knowledge consumers (according to James H. McAlexander and Debra Scammon’s article “Are Disclosures Sufficient? A Micro Analysis of the Impact of the Financial Services Market” in the Journal of Public Policy and Marketing).

It is certainly a challenging political position to publicly disagree with calls for more disclosure. But we would like to see the Commission explore the academic research that suggests that the focus should not be on more disclosure but on making disclosure more meaningful. We need to move away from the debunked theory undergirding the current disclosure-mandate approach and work with practitioners to generate new solutions to advance client knowledge and engagement.

CONCLUSION
It is often unpopular to raise substantive questions such as those outlined in this brief paper. We are concerned that in the midst of a passionate debate, certain important ethical questions are not getting the attention they deserve. The goal of investor protection is crucially important, and we hope you will take these points into consideration.

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